Nos. 12471, 12472, 12473, 12474, 12475, 12476

# In the United States
# COURT OF APPEALS
## for the Ninth Circuit

SAM SCHNITZER,

ESTATE OF HARRY J. WOLF, Deceased, by Monte L. Wolf, Administrator, de bonis non with the will annexed of said estate,

MONTE L. WOLF,

BLOSSOM M. GOLDSTEIN,

CHARLOTTE C. COHON,

ESTATE OF JENNIE WOLF, Deceased, by Monte L. Wolf, Administrator de bonis non with the will annexed of said estate,

*Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

## BRIEF FOR THE APPELLANT

On Appeal from the Tax Court of the United States.

ROBT. T. JACOB and
JACOB & BROWN,
*Attorneys for Petitioners.*

GARTHE BROWN,
*Of Counsel.*

STEVENS-NESS LAW PUB. CO., PORTLAND 4-50

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Nos. 12471, 12472, 12473, 12474, 12475, 12476

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## BRIEF FOR THE APPELLANT

On Appeal from the Tax Court of the United States.

## CONSOLIDATION OF APPEALS

On motion of petitioners, on February 15, 1950 this Court ordered that the above entitled proceedings be consolidated for purposes of the printed record, brief,

hearing, argument, decision and all other purposes connected with the final disposition of said proceedings (R. 547-549).

## JURISDICTION

This appeal is from a decision of the Tax Court of the United States entered November 9, 1949 (R. 71).

On March 3, 1947 the Commissioner of Internal Revenue mailed petitioners, Sam Schnitzer, Harry J. Wolf and the Estate of Jennie Wolf, Notices of Deficiency in income and victory taxes for the taxable year 1943 (R. 16) and on March 4, 1948 said Commissioner mailed notices to Monte L. Wolf, Blossom M. Goldstein and Charlotte C. Cohon covering proposed deficiencies in income and victory taxes for the taxable year 1943 as transferees of the estate of Jennie Wolf, who died on April 8th, 1945 and Monte L. Wolf is administrator de bonis non of her estate. Harry J. Wolf died February 6, 1948, and Monte L. Wolf is executor of his estate. Petitioners appealed to the Tax Court from these proposed deficiencies within the time provided by Section 272 of the Internal Revenue Code (R. 2 et seq.). The Tax Court's jurisdiction is set forth in Sections 1101 and 272 of the Internal Revenue Code.

As set out in the petitions for review, petitioners are residents of Portland, Oregon, and filed their income and victory tax returns with the Collector of Internal Revenue for the District of Oregon, whose office is located within the ninth judicial district, wherein petitioners also reside. This court has jurisdiction to review the

Tax Court's decision under the provisions of Sections 1141 and 1142 of the Internal Revenue Code (26 U.S. C.A., Sections 1141 and 1142) and Title 28 U.S.C.A., Section 2106.

## STATEMENT OF THE CASE

During the years 1942-1943 Sam Schnitzer and Harry J. Wolf were active in the operation of Alaska Junk, a partnership, engaged in the business of dealing generally in machinery, junk, scrap and other metal products in Portland, Oregon. The partnership books were kept on the accrual basis (R. 34).

H. J. and Jennie Wolf were married in 1906, and Mr. Wolf learned the junk business from his father-in-law, and as Mrs. Wolf was also familiar with the junk business they decided to operate independently. She had a dower of $1,000.00 and this was used to buy a horse and wagon (R. 34). About the same time Sam Schnitzer began to deal in scrap metal, and in 1911 Wolf and Schnitzer entered the junk business as partners and operated as Alaska Junk Co. (R. 35).

As Alaska Junk expanded its activities and grew in financial strength it made loans or advances to customers in the expectation of maintaining or increasing its trade. Most of the advances were repaid in cash or scrap, but some were not (R. 38).

Alaska Junk also made "very large" advances to enterprises in which petitioners' families were interested. Some of these advances were made AS LOANS and

some for CAPITAL STOCK. Alaska Junk kept open accounts with all of the businesses to which said advances were made, charging them with cash and merchandise furnished and crediting them with cash and goods received (R. 39-40).

On June 4, 1941 Morris Schnitzer, son of Sam Schnitzer, organized the Oregon Electric Steel Rolling Mills with authorized capital of $250,000.00 represented by 2,500 shares. On the same date Morris Schnitzer and his attorney, Louis Schnitzer, subscribed for 1,251 shares (control) and Sam Schnitzer and Harry J. Wolf each subscribed for 312½ shares. February 10, 1942, 1,251 shares were issued to Morris Schnitzer and 312½ each to Sam Schnitzer and Harry J. Wolf (R. 40-41). Oregon Steel never issued more capital than $187,800.00 (R. 48). Oregon Steel was organized to erect and operate a mill to roll steel products. Petitioners expected it to provide a local market for their scrap, and engineers estimated it would eventually earn $50,000.00 or more per month. Morris Schnitzer, educated in engineering and business administration and with wide experience in related operations, originated the idea and arranged for organization and financing of Oregon Steel (R. 41).

Alaska Junk made large advances, supplied merchandise and paid bills for Oregon Steel, and charged same to an open account with that company. All such charges were credited to Alaska Junk by Oregon Steel (R. 42).

Morris Schnitzer made numerous attempts to procure outside capital (R. 43). RFC finally approved a loan of $700,000.00 (R. 44). Payment of this loan was

guaranteed by petitioners, who also agreed to supply "additional working capital" and not to require payment of their advances during pendency of the loan except in common stock or debenture notes (R. 45). RFC did repay $114,519.88 of these advances (R. 46).

Alaska Junk obtained an agreement from Morris Schnitzer to assume one-third of any loss which might be jointly sustained by reason of advances, and March 11, 1943, Alaska Junk took over one-half of his stock (R. 47), Morris having received his second notice of induction into the armed forces February, 1943 (R. 92). Oregon Steel was unable to obtain a competent manager. It experienced great difficulty in getting into operation and closed down November, 1943. The stockholders sold their stock for 1¢ per share. Before doing so Oregon Steel gave Alaska Junk its note for $427,843.87, and Morris Schnitzer a note for $26,829.28 (R. 49-50).

Purchasers elected new officers and directors and with consent of RFC Oregon Steel gave its note for $249,000.00 secured by second mortgage and its note for $151,000.00 secured by third mortgage. By accepting notes for $151,000.00 for previously issued notes the five stockholders of Oregon Steel lost $303,625.90 due for advances on open account, which account at that time showed balance of $454,625.90. Based upon compromise of the debts, Alaska Junk lost $202,350.60, and this amount was charged off as a bad debt (R. 51-52).

This loss is the subject matter of this appeal. The respondent disallowed the deduction and the Tax Court sustained his position.

## SPECIFICATION OF ERRORS

I.

The Tax Court erred in holding that the bad debt of $202,350.60 charged off by the partnership in which petitioners were partners was not a bad debt and not deductible in computing petitioners' taxable net income for the year 1943.

II.

The Tax Court erred in holding that the total, or any amount in excess of $125,000.00, representing bills paid for, cash advanced to, and goods sold to Oregon Electric Steel Rolling Mills by Alaska Junk Co. constituted a contribution to the capital of said Oregon Electric Steel Rolling Mills.

III.

The Tax Court erred in not finding and holding that the entire sum of $202,350.60 was a debt owed to Alaska Junk Co.

IV.

The Tax Court's decision herein is contrary to law, the findings of fact and the evidence; it is not supported by said findings of fact or the evidence, but is in disregard of both said findings and evidence.

V.

The Tax Court made the following finding:

> "From October, 1941 Alaska Junk made numerous advances of cash to Oregon Steel; supplied it with goods of various kinds 'at cost' and paid bills for it. . . . On an office memorandum Sam Schnitzer referred to these advances as 'contributed capital'."

The Tax Court erred in finding: (a) that the goods which Alaska Junk supplied to Oregon Steel were supplied at cost, (b) that Sam Schnitzer ever wrote an office memorandum referring to the advances as "contributed capital" or using words of similar import.

VI.

The Tax Court erred in failing to include in its findings the following material facts:

(a) Alaska Junk made advances of merchandise, services and cash to National Machinery Company, a subsidiary corporation. Subsequently the latter concern was liquidated, and the unpaid account of $30,437.17 was charged off as a bad debt by Alaska Junk and deducted on its tax return and allowed by the Commissioner (R. 198-199, 292-293, 360-362).

(b) Hesse-Ersted Company, which ran a machine shop, was in serious financial straits in 1941. Alaska Junk assisted it financially by loaning it $65,000.00, to enable it to complete a large contract. As a result Alaska Junk secured Hesse-Ersted as a substantial customer, whereas prior to that time dealings with it had been only casual (R. 188-189, 236-237, 321).

VII.

The Tax Court erred in determining that there was a deficiency in income and victory taxes for the calendar year 1943 due from petitioners herein.

## STATUTES INVOLVED

Set forth in the appendix, infra.

# SUMMARY OF ARGUMENT

## I.

## Introductory

1. The Issue.

There is but a single, simple issue: Were advances made by the stockholders through their business partnership to Oregon Steel, in accordance with a long established practice of making such advances for increasing the partnership's business, capital contributions or debts?

2. Petitioners' Business Includes Making Advances as Loans.

Petitioners' partnership, Alaska Junk, was organized in 1911, and over its thirty years of operation it had made a practice of making advances to business enterprises for increasing its business.

3. The Loss Deduction Arose from Settlement of the Debt.

After Morris Schnitzer (the promoter and owner of controlling stock of Oregon Steel) was called into military service, Oregon Steel fell apart and the stockholders decided to sell their stock. The corporation, by its new officers, compromised the debt by giving a note secured by a third mortgage on Oregon Steel's real and personal property on the basis of its indebtedness to the former stockholders and not on the basis of stock ownership.

## II.

## The Trier's Findings of Fact

### 1. The Primary Facts Found Are Correct in the Main.

The following findings are excepted to:

(a) That on an office memorandum Sam Schnitzer referred to the advances as "contributed capital";

(b) That the goods which Alaska Junk supplied to Oregon Steel were supplied "at cost";

(c) That the court failed to find that included amongst the concerns to which Alaska Junk made advances were National Machinery Company, a subsidiary corporation, and Hesse-Ersted Company, a large user of petitioners' merchandise.

### 2. Primary Facts Found Require Ultimate Finding That the Controverted Advances Were Debts.

The primary facts found by the court expressly include all of the essential elements of an indebtedness and the loss resulting therefrom; the advances were made and merchandise sold; the funds and merchandise were accepted; the books of the vendor and vendee recorded the transactions as accounts receivable and accounts payable respectively; $114,519.88 of the advances were repaid by RFC; all entries conform to the established method of creating debtor-creditor relationship; and the debt was recognized and settled by compromise payment.

## III.

## Trial Court's Erroneous Findings and Conclusions

1. Erroneous Inferences Drawn from Primary Facts.

An analysis of the various evidentiary facts upon which the court apparently relied as a basis for its adverse inferences clearly shows that said inferences are based upon a misconstruction of the evidence and are in direct contradiction to positive, primary facts competently found.

2. The Trier's Errors of Law.

Also, an analysis of the factors considered and the rules of law applied by the trier demonstrates an equally gross misconception of the legal principles governing the determination of the issue.

## IV.

## Review of the Entire Record to Determine Error

It is submitted that even though upon consideration of the primary facts found by the trial court, this court concludes these facts support the ultimate findings, nevertheless under the present FRCP and the decisions relating thereto this court must review the entire record to determine whether a mistake has been committed; the only limitation upon this review is that a conflict in the oral testimony of witnesses will not be resolved.

# ARGUMENT

## I.

## Introductory

1. The Issue.

A single issue is presented. Were open account advances debts or capital contributions?

Within the last year this court has twice passed upon the issue involved in the instant case. In *Maloney v. Spencer,* 172 F. 2d 638 (C.C.A. 9th, 1949), Chief Judge Denman wrote a comprehensive opinion on the question of advances by a stockholder to his wholly owned corporations. In *Wilshire & Western Sandwiches, Inc. v. Commissioner,* 175 F. 2d 718 (C.C.A. 9th, 1949), Judge Orr also fully discussed the law applicable to the issue.

2. Petitioners' Business Includes Making Advances as Loans.

In order for the issue involved to be rationally and fairly resolved, it must be considered in the business setting surrounding the controverted transactions.

Through their partnership, Alaska Junk, petitioners made advances to Oregon Steel in accordance with a long established business practice of making such advances "in the expectation of increasing or expanding their business". Were these advances INTENDED TO ENLARGE THE CAPITAL of Oregon Steel, or were they INTENDED TO CREATE A DEBT?

There is no intimation that the controversial transactions involve sham, artifice or the "statutory literalness" condemned in *Gregory v. Helvering,* 293 U.S. 465 (1935). Nor is tax avoidance so much as hinted at. Also, the facts present a much stronger case for petitioners than the single, isolated, stock-note transactions involved in tax avoidance cases, such as *Janeway v. Commissioner,* 147 F. 2d 602 (C.C.A. 2d, 1945); *1432 Broadway Corporation v. Commissioner,* 160 F. 2d 885 (C.C.A. 2d, 1947); *Mullin Building Corporation,* 9 T.C. 350 (1947). The challenged advances were made by a partnership engaged in business, as distinguished from an individual not engaged in a trade or business, and such advances were made in conformity with a long established business practice; they were only incidentally connected with a stock subscription; and in a compromise settlement of the debt the petitioners received 33.2141% of the account. The entire course of petitioners' conduct and their actions throughout point to a single purpose and intention, and there is nothing therein to cast doubt on the existence of the debtor-creditor relationship.

Petitioners had a large business and they stood high in the community. E. B. McNaughton, Chairman of Board of the First National Bank of Portland, called by respondent, in referring to Sam Schnitzer and Harry J. Wolf, testified (R. 441):

> "These men were phenomenal successes as salvage merchandise dealers, starting at almost pushcart level, and they had worked themselves up to be *one of the most successful clients or customers the bank had; . . .*"

A. W. Groth, Vice President of the same bank, also respondent's witness, testified (R. 489):

> " . . . In the case of responsible people, such as the Schnitzers and Wolfs with whom we have had business dealings over a period of years, and who have always worked in close cooperation with us and in entire honesty with the bank, we would take their word for it, whatever they would say."

(R. 496):

> "We had confidence in the Schnitzer family and the Wolf family, based on many years of successful banking experience, and we took their word."

We find adequate recitals in the court's findings of the growth and development of petitioners' business.

Petitioners, Harry J. Wolf and Sam Schnitzer, began in the junk business as early as 1906. Wolf used his wife's dowry to buy a horse and wagon, which in 1911 he contributed to a partnership called Alaska Junk Co., and toward which Schnitzer paid about $1,000.00. This partnership continued in the business of buying, selling and generally dealing in junk, pipe, tools, machinery, hardware, scrap and other metal products, and kept its books on the accrual basis.

As Alaska Junk expanded its activities and grew in financial strength it made loans or advances to customers and to enterprises in which petitioners were interested, in the expectation of maintaining or increasing its trade. Stock was subscribed and paid for in some of these enterprises in identically the same manner as the instant transaction. The partnership kept open accounts with all the persons to whom advances were made and

merchandise sold, charging to such accounts all cash and merchandise and crediting them with payments.

On June 4, 1941 Morris organized Oregon Steel with authorized capital $250,000.00, represented by 2,500 shares. On that date stock was subscribed for and on February 10, 1942 1,251 shares (control) were issued to Morris Schnitzer and 312½ each to Sam Schnitzer and Harry J. Wolf.

Oegon Steel was to erect and operate a rolling mill for the manufacture of steel products, from scrap metal, and on the basis of engineers' estimates expected earnings of $50,000.00 or more a month. Morris Schnitzer originated and headed the project. He was experienced in merchandising iron, steel, tools and machinery and salvage enterprises throughout the country, and was educated in engineering and business administration.

From October, 1941 (more than four months after the stock subscription) Alaska Junk made numerous advances of cash to Oregon Steel, supplied it with goods of various kinds and paid bills for it and charged these items to Oregon Steel on open account. All charges were reflected by corresponding credits on Oregon Steel's books.

These facts, competently established, create a business background of honesty, integrity and successful dealings which must be given full significance in the determination of the issue involved. The controverted transaction is simply one in a long series of identical transactions entered into by the petitioners through their partnership, Alaska Junk (using the literal language of

the court) "in the expectation of maintaining or increasing its trade," and it is strikingly unlike the situations in which a single stockholder or a family group suddenly realizes that by reorganizing their corporation and substituting notes or bonds for capital stock they may obtain interest in lieu of dividends and thereby provide the corporation with a tax deduction. Nor is this a case where tax considerations entered into the transaction in any particular, but the transaction follows a pattern of long standing.

By 1941 Alaska Junk had become a large dealer in scrap metal and was obtaining an inadequate price for it. Morris Schnitzer, an ambitious young man with business education and experience, proposed to establish a rolling mill operation as an outlet for this scrap. He consulted engineers and obtained data which indicated monthly profits of $50,000.00 or more; he interested his father and his father interested his partner, Wolf, who proved to be a reluctant participant, but step by step he was led to agree to permit the partnership to subscribe for a maximum of $125,000.00 of Oregon Steel stock. Obviously without any instructions from the petitioners to record the transactions with a view to laying the foundation for a "tax loss," the bookkeepers of Alaska Junk and of Oregon Steel simultaneously recorded the transactions identically as all previous transactions of the same kind had been recorded. Undoubtedly the trial court completely lost sight of these significant facts which he so clearly recorded in arriving at his conclusion that the advances were paid in as risk capital and not as loans.

### 3. The Loss Deduction Arose From the Settlement of a Debt.

When Hall and Mears purchased Oregon Steel's stock and elected a new board of directors, the advances were still a liability (an account payable) of Oregon Steel, and the debt represented by this account payable was settled on behalf of the new owners of Oregon Steel by the execution of a SECURED note for $151,000.00 covered by a third mortgage on the company's real and personal property. The account is at this point recognized as a debt. No change took place in it from its inception, yet the court treated it as a capital contribution. Was a "capital contribution" then converted to a debt? Did the "leopard change its spots"?

Petitioners' Exhibit 22, Minutes of Special Meeting of Directors of Oregon Steel of Nov. 26, 1943, contains the following:

> "The said S. Schnitzer then stated that the Oregon Electric Steel Rolling Mills was then indebted to the Alaska Junk Company in the sum of $427,843.87, as evidenced by a note dated November 26, 1943, and that the corporation was then further indebted to Schnitzer Steel Products, of which Morris Schnitzer is the sole owner, in the sum of $26,829.28, as evidenced by promissory note dated November 26, 1943.
>
> "It was agreed that the holders of said notes would compromise said indebtedness for the sum of $151,000.00, to be evidenced by a promissory note secured by a third mortgage on the corporation's real property and most of its personal property. A proposed form of note and third mortgage was then submitted. An exhibit describing the personal property to be specifically mortgaged was attached to the form of mortgage.

"On motion duly made and seconded and adopted by unanimous vote, it was

"RESOLVED that the President and Secretary of the corporation be and are hereby authorized and directed to execute said note and third mortgage in exchange for the surrender of the above described promissory note.

"Thereupon said note and mortgage were executed by the President and Secretary of the corporation and were duly offered in compromise and surrender of said promissory notes. The offer was accepted and the said promissory notes were then and there surrendered in consideration of the delivery of said note and third mortgage."

It is particularly significant to this issue that the new owners of the stock recognized the obligation of Oregon Steel to the Alaska Junk as an indebtedness and accepted an offer to compromise said indebtedness for $151,000.00 and agreed to issue a note for this amount (secured by a mortgage on the corporation's real and personal property) in full satisfaction of the indebtedness. They had paid only 1¢ per share of $100.00 for the stock of Oregon Steel. (Loss from the sale of the stock is not involved in this case.)

In *Maloney v. Spencer,* 172 F. 2d 638 (C.C.A. 9th, 1949), this court in citing with approval *Van Clief v. Helvering,* 135 F. 2d 254, 256, copied the court's quotation from *Edward Katzinger Co. v. Commissioner,* 44 B.T.A. 533, 536, as follows:

"'. . . Here the parties intended the advances as loans. This is shown not only by the testimony of the officers, *but by the entries on the books of the two companies and the consistent actions of the parties in regard to the advances, including their*

> *actions incident to the liquidation*'." (Italics supplied)

In copying this quotation this court italicized the portion of the sentence relating to the entries on the books, the consistent actions of the parties in regard to the advances and their actions incident to the *liquidation of the corporation.* This emphasizes the petitioners' position, as all the factors considered in that case are present here and are strengthened by the clear, uncontradicted testimony of several witnesses as to the intention of the petitioners.

Refer further to paragraph 31 of stipulation (R. 535), which reads in part:

> "On November 26, 1943, Oregon Steel executed and delivered to Alaska Junk a promissory note in the amount of $427,843.87 as evidence of the advances made to it by Alaska Junk as of that day, shown by the books of Oregon Steel. Exhibit 20 is a photostatic copy of said note. . . ."

As stated in the stipulation, this note was given "as evidence of the advances made to it by Alaska Junk." Thus the respondent admits that the note which was compromised and settled evidenced the advances thereby recognizing the debtor-creditor relationship.

The note, Exhibit 20, bears this endorsement on its face:

> "Compromised and cancelled in consideration of delivery of third mortgage."

## II.

## The Trier's Findings of Fact

1. The Primary Facts Found Are Correct in the Main.

Notwithstanding the correctness of many primary facts found, the court seriously erred in the following particulars:

(a) The court found (R. 43):

> "On an office memorandum Sam Schnitzer referred to those advances as 'contributed capital'."

There is no evidence in the record upon which to base this finding, but it is evident the court's conclusions were influenced by it. It refused to accept the testimony of petitioners' witnesses on this point on the ground that the statements and conduct of petitioners did not support their testimony. Obviously this finding aided in directing the court's thinking to the prejudice of petitioners.

(b) The court also found (R. 42):

> "From October, 1941 Alaska Junk made numerous advances of cash to Oregon Steel; supplied it with goods of various kinds at cost. . . ."

This finding is clearly contrary to the record.

Morris Schnitzer, the promoter and manager of Oregon Steel, testified (R. 95):

> "Q. At what prices, when Oregon Steel bought from Alaska—— what prices did you pay to Alaska for merchandise out of their stock?

A. We paid the standard prevailing price.

. . . . .

Q. . . . I want to call your attention to the things that were purchased for the construction of the mill before you went into the service; do you know on what basis or on what price that merchandise was purchased?

A. We paid the standard prices for what was purchased, which standard prices were gauged by the Moore Book, which was the book that the Portland Jobbers Association paid, or what they went by. That was for scrap. For new steel that was fabricated, we paid the jobbers' price; for electric motors and so forth, the same."

(R. 370) After explaining his duties with Alaska Junk and the pricing of merchandise, Monte L. Wolf testified (R. 371):

"Q. At what price was the merchandise sold to Oregon Steel?

A. At the regular prevailing market prices. Piping is based upon Moore's Pricing Manual."

Insofar as the sale of merchandise to Oregon Steel is concerned, Alaska Junk was in identically the same position as though it were dealing with outside parties. It was dealing "at arm's length" as to merchandise furnished, which amounted to $347,341.62. To that extent it found an outlet for its merchandise, realized its normal profit and paid to the government its regular taxes thereon. If the stock subscription were not involved, there could be no question raised about the validity of petitioners' claim for the deduction of the challenged loss. We say that the other circumstances complained of by the court do not affect petitioners' rights and have not, in any wise, changed their status as bona fide credi-

tors under the obligation created by supplying the merchandise, cash and credit.

(c) The court failed to make any finding with respect to the advances made to National Machinery Company, a subsidiary corporation, and Hesse-Ersted Company, a large outlet for petitioners' merchandise. This omitted finding is another indication of the court's lack of full knowledge of the evidence in the record. Manuel Schnitzer testified (R. 198):

> "Q. Did the Alaska Junk Company have any business relation with the National Machinery Company?
> A. Yes.
> Q. What?
> A. We sold them a tremendous amount of merchandise.
> Q. Did you ever supply them any cash?
> A. Yes."

M. R. Schnitzer testified (R. 292):

> "The Court: How many sheets are there?
> The Witness: Forty-nine pages. . . . Total pages; that is the original records of the Alaska Junk Company accounts receivable with the National Machinery Company of Eugene. . . (R. 293) It is the record of the merchandise and cash advances to the National Machinery Company of Eugene, which was a subsidiary corporation of the Alaska Junk Company, for the period of January 1, 1928 until December 31, 1933, when it was written off and closed."

(R. 360):

> "Q. I am handing you National Machinery Company account, and I want you to state whether there was a bad debt there?
> A. Yes, we wrote off $30,000 odd in 1933."

Following the above testimony the witness testified that the bad debt loss on account of National Machinery Company of $30,437.17 was deducted on the 1933 Federal tax return and was allowed in the Revenue Agent's report on behalf of the Commissioner (Ex. 56). The court's failure to make a finding with respect to this deduction of a bad debt loss in connection with a subsidiary company of the Alaska Junk Company is another circumstance in the chain which influenced the court in its adverse holdings.

Regarding the Hesse-Ersted account, reference is made to the testimony of Manuel Schnitzer. After naming Hesse-Ersted Company he was asked (R. 236):

> "Q. What was the nature of the advances made to them?
>
> A. We made cash payments for them, we got a mortgage from them. . . . for $50,000 or $60,000."

This witness repeated his testimony at R. 189 wherein he stated that the company operated a machine shop and Alaska Junk saw an opportunity to make a profit by assisting them through buying or selling materials (R. 321). This testimony was corroborated by M. R. Schnitzer (R. 322). He further testified that Hesse-Ersted purchased machinery for their use and that that transaction was indicative of many such transactions, including Western Foundry, Vaughn Motor Works, etc.

A consideration of all of these items was necessary in order to give proper weight to the entire record, and a failure to give consideration to the record in its entirety, obviously, was seriously prejudicial to petitioners.

## 2. Primary Facts Found Require Ultimate Finding That Controverted Advances Were Debts.

An analysis of the primary facts found by the Tax Court shows clearly that the advances were made under such circumstances as to require the conclusion they created the debtor-creditor relationship. The court's findings expressly include all the essential elements of an indebtedness and the loss therefrom, viz: the advancement of the funds, payment of bills or sale of merchandise; a meeting of the minds evidenced by acceptance and use of the funds and merchandise by the vendee; expectation of reimbursement as shown by charges on the books of the vendor; acknowledgement of the debt and agreement to pay evidenced by credits to the vendor on the books of the vendee; all entries relating to the transaction conforming to a long established practice and method of creating a debtor-creditor relationship; and settlement of the debt by compromise and partial payment.

Adopting the language of the court, it found:

> ". . . Sam Schnitzer and Harry J. Wolf were active in the operation of Alaska Junk Co. . . . a partnership engaged in . . . dealing in junk, . . . machinery, . . . scrap and other metal products . . . Its books were kept on an accrual basis, . . . (R. 33-4)
>
> "As Alaska Junk expanded its activities and grew in financial strength, it occasionally made loans to customers in the expectation of maintaining or increasing its trade. . . . (R. 38)
>
> "Alaska Junk also made very large advances to enterprises in which members of the Wolf and

Schnitzer families were interested. . . . The partnership kept open accounts with all the persons and firms to whom the above mentioned advances were made, charging to such accounts all cash advanced and merchandise furnished, and crediting them with payments in cash or in goods bought by it. (R. 39)

"On June 4, 1941, Morris Schnitzer, son of Sam Schnitzer, organized the Oregon Electric Steel Rolling Mills . . . with an authorized capital of $250,000.00, represented by 2,500 shares and on that date Morris Schnitzer and Louis Schnitzer, his attorney, subscribed for 1,251 shares and petitioners, Sam Schnitzer and Harry J. Wolf 312½ shares each . . . on February 10, 1942, 1,251 shares were issued to Morris Schnitzer; 312½ to Sam Schnitzer and 312½ to Harry J. Wolf. . . . (R. 40-1)

"No other shares were ever issued although in the beginning the organizers expected to issue more to associate promoters. (R. 48)

"Oregon Steel was organized to erect and operate a rolling mill for the manufacture of steel products. Its stockholders planned to melt down and use scrap metal, which in 1941 was being sold in Portland at $1.50 to $2 a ton less than in Seattle, and on the basis of engineers' production estimates expected the earnings eventually to reach $50,000 or more a month. . . . (R. 41)

"From October 1941 Alaska Junk made numerous advances of cash to Oregon Steel; supplied it with goods of various kinds at cost and paid bills for it. The amounts of cash advanced, the bills paid and value of the goods furnished were charged to its open account with Alaska Junk. . . . All . . . charges were reflected by corresponding credits to the accounts of Alaska Junk . . . on the corporation's books. . . . (R. 42)

" . . . in November 1943 they ceased operations, and . . . decided to . . . sell all their shares . . . for one cent a share. Before so doing,

they had the corporation give to Schnitzer Steel Products Co. its promissory note for $26,829.28 and to Alaska Junk its promissory note for $427,843.87 . . . equal to the respective credit balances shown on that date in the payees' open accounts with the corporation, . . . (R. 50) . . . Immediately after the sale the purchasers elected new officers and directors, . . . It (Oregon Steel) also gave them . . . its 6 per cent note for $151,000 . . . secured by a third mortgage on its property . . . (R.51)

"By accepting the $151,000 note in exchange for the two newly made promissory notes, the five former stockholders . . . failed to recover $303,-625.90 . . . due from the corporation for their advances on open account, . . . Alaska Junk then charged off $202,350.70 on its accounts with the corporation as a bad debt. (R. 51-2)

" . . . By 1947 corporate surplus exceeded a million dollars. Since November 26, 1943, and to the present time Oregon Steel has purchased large quantities of scrap from Alaska Junk." (R. 52)

It is difficult to conceive a more clear-cut narration of facts essential to the creation of the debtor-creditor relationship. There is nothing in the sequence of events relating to the transactions which so much as suggests any intention on the part of the petitioners to pay in any part of these advances as capital, except to the extent that entries reflect a charge on the books of Oregon Steel on March 31, 1943 of $124,900 "to offset balance of stock subscription due against capital Acc. Pay.," and the corresponding entries of July 14, 1943 on Alaska Junk's books reflect contra entries.

It should be noted that the court commented after detailing the entry on Oregon Steel's books (R. 47) " 'to

offset bal. of stock subscriptions due against Acc. Pay.,' LEAVING A BALANCE OF $315,095.41 IN THAT ACCOUNT (account payable)." Petitioners had set the amount of debentures and stock they would accept and chose to leave the balance as an account due them. Appropriate contra entries were made on the books of Alaska Junk. Additional shares of Oregon Steel's stock were available, but obviously petitioners had refused to accept more shares than those subscribed for.

These findings clearly demonstrate: the advances were made in accordance with a consistent business policy of long standing for expanding petitioners' regular business of "buying, selling and generally dealing in junk, . . . scrap and other metal products . . ."; a maximum authorized capital for Oregon Steel of $250,000 fixed upon incorporation; a definite REFUSAL to enlarge it; Alaska Junk's subscription for stock intended to be purchased, made more than four months before any advances were made; settlement of the account by a compromise; the expectation of large profits from Oregon Steel; the eventual outstanding success of the venture and the establishment of a market for Alaska Junk for "LARGE QUANTITIES OF SCRAP" (the very result sought by Alaska Junk); and the final step of writing the loss off as a bad debt.

These and other facts found forcefully corroborate the testimony of petitioners' witnesses. The court should have accorded it full credence, and its failure to do so was plain error. The Trial Court's misstep in reasoning seems to have had its genesis in the fact that it approached the determination of this problem from the

wrong premise. It disregarded the inferences to be drawn from the patent facts pointing toward the EXISTENCE of the debtor-creditor relationship from the day the advances were made, and has required petitioners to assume the burden of overcoming unwarranted inferences and to ESTABLISH THE EXISTENCE of this relationship by an overwhelming preponderance of evidence. The natural, logical inference to be drawn from the facts found is that a loan was intended, but the court obviously closed its eyes to a reasonable construction and chose to wander far afield in search of something to support an ill conceived inference.

In *Kramer v. Gardner,* 104 Minn. 370-3, 116 N.W. 925, 926 (1908), in defining an open account as a debt, the court stated:

> ". . . The expression 'outstanding and open account' has a well defined and well-understood meaning. In legal and commercial transactions it is an unsettled debt arising from items of work and labor, goods sold and delivered, and other open transactions, not reduced to writing and subject to future settlement and adjustment."

The books of ALL PARTIES fully support the contention of petitioners. The accounting followed the nice exactitudes of proper and fully sanctioned business principles. There was not the slightest deviation from the most orthodox standard. Not with any thought of "window dressing" to lay the foundation for a tax deduction, but with one view in mind: to record correctly the actual transactions and in the same manner all previous like transactions had been recorded. This is susceptible

ONLY of the inference the parties INTENDED the advances to constitute debts. All was done that was ever done in business transactions of this kind. Monies were advanced; merchandise was sold at regular prices; invoices were rendered and recorded by Alaska Junk, the vendor, as accounts receivable; the cash and merchandise were received and the obligations were acknowledged and recorded as accounts payable to Alaska Junk by Oregon Steel, the vendee. The transaction was thereby completed and a DEBT created in the manner customary in trade, and consistently followed by Alaska Junk for many years.

All of these facts were found by the court yet it brushed them aside as meaningless. A plain misstep in reasoning.

## III.

## The Trial Court's Erroneous Findings and Conclusions

### 1. Erroneous Inferences Drawn By Trier.

That the court's reasoning is fallacious is obvious from an analysis of the various items of evidence from which it drew the adverse inferences.

The question is whether the challenged advances created a debt. We say a prima facie case is made out by the evidence recording the transactions in question on the books of the various parties involved: the positive testimony of witnesses that the parties intended to cre-

ate a debt: and the recognition and settlement of the debt by the new owners. The witnesses were not impeached, their testimony is not "inherently improbable" and an analysis of the negative evidence upon which the court relied as rebutting the bookkeeping entries and the oral testimony clearly demonstrates they were misconstrued by the court.

(a) *Re Office Memorandum* (R. 43). The court found that on an office memorandum Sam Schnitzer referred to the advances as "contributed capital." There is no such memo in the record and petitioners have no knowledge of such a memo being in existence. Assuming such a memo had been issued, the use of the term had no significance. (See A. W. Groth, R. 490-1, particularly 492.)

> "They might have, in fact, been referring to advances by the stockholders or investment in capital stock."

(b) *Re attempts to procure outside capital* (R. 43). No adverse inference may be drawn from attempts to procure outside capital. On the contrary this supports petitioners' position, as it clearly demonstrates a consistent refusal to increase Oregon Steel's capital over $250,000.00, and at the same time an attempt by Morris to induce others than petitioners to invest in his company. This was a big project for Morris, the promoter, and if he had had the assurance of petitioners that they would agree to an increase in capital he would have been eager to give that assurance to the financial institutions approached.

By refusing to increase the capital stock Morris

deprived himself of an opportunity to obtain outside financing. Commercial Credit and Giannini of Bank of America specifically informed Morris that if he would increase the capital of the corporation they would be interested in assisting in his financing (R. 104, 152-3).

(c) *Re Statement on RFC Application* (R. 43). This statement that additional stock would be taken by Sam Schnitzer and H. Wolf was not made by either of the petitioners but by Morris, the promoter, at which time, October, 1941, he had a controlling interest in Oregon Steel, 1,251 shares, and this statement meant nothing more than that Morris hoped petitioners or others would subscribe for the balance of the authorized capital. Petitioners did eventually take additional stock, which was released by Morris at the time he was called for military duty. This statement in no wise reflected any INTENTION of petitioners.

(d) *Re Guaranty of Note and Agreement to Supply "Additional Working Capital"* (R. 45). Guaranty of the RFC first mortgage note has no bearing upon the issue. The agreement to supply additional monies related to "working capital" only. There is no intimation here of subscribing for additional stock. "Working capital" has no relation to the capital stock of a corporation. Working capital is defined in the Accountants Hand Book, Third Edition, 1943, at page 59, as follows:

> "Statement of Working Capital.—A statement of working capital (excess of current assets over current liabilities) is a tabulation of current assets and current liabilities designed to emphasize current financial condition. . . ."

The excess of current assets over current liabilities in no sense tends to "enlarge stock investment." Working capital fluctuates daily, varying with the ratio of cash, accounts receivable, inventory and other current assets to notes, accounts and other obligations payable "within ONE YEAR," while stock investment connotes a corporation's permanent investment, which remains constant throughout each year unless additional capital stock is issued or there are additions to surplus, either earned or paid in.

(e) *Re Instrument Dated December 29, 1941 (apparently 1942)* (Resp. Ex. R (R. 45). Obviously this statement, Respondent's Exhibit R, was prepared by RFC, was presented to the parties and signatures demanded. While it refers to Alaska Junk as having contributed as a capital investment $299,069.70, reference to testimony of A. W. Groth (R. 492) where he states:

> "They might have, in fact, been referring to advances by the stockholders or investment in capital stock."

shows the use of words was not significant. It also shows RFC left open to petitioners the privilege of receiving additional debenture notes, which notes unquestionably are debts. This agreement also states that Alaska Junk *"has contributed* as capital investment, etc." This statement is in the past tense and refers only to advances made up to that time. Alaska Junk accepted stock of $125,000.00 and received debenture notes of $174,000.00. These two items total $299,000.00, which is the amount of Alaska Junk's advance in even thousands, the $69.70 having been omitted for convenience.

The last paragraph of this agreement reads:

"This agreement is given for the purpose of inducing RFC to disburse said loan, and in consideration of the disbursement thereof in whole or in part."

Respondent's Exhibits X, Y and Z, representing the financial statements supplied by Oregon Steel, all show the advances as a liability to the stockholders, and, in no sense, indicate that they are intended to represent capital investments.

Attention is also called to Exhibit 65, showing the classification of Alaska Junk's account with Oregon Steel, furnished as follows:

"SUMMARY OF ALASKA JUNK COMPANY ACCOUNT WITH OREGON ELECTRIC STEEL ROLLING MILLS

| | Cash Advance Debited | Bills Paid, Etc. Debited | Merchandise Furnished Debited | Cash Receipts (Credited) | Debit Balance |
|---|---|---|---|---|---|
| ct. 22, 1941 to Nov. 30, 1942 | $ 42,600.00 | $137,259.04 | $122,823.07 | $ (1,000.00) | $301,682. |
| ec. 1, 1942 to Nov. 25, 1943 | 285,270.23 | 29,081.12 | 224,518.55 | (113,519.88) | 425,350. |
| | $327,870.23 | $166,340.16 | $347,341.62 | $(114,519.88) | $727,032. |
| educt— | | | | | |
| Stock | | | | $124,900.00 | |
| Debentures | | | | 174,000.00 | 298,900. |
| alance Nov. 25, 1943 | | | | | $428,132.1 |

It will be noted that merchandise furnished is debited with $347,341.62 and credited with repayments thereon of $114,519.88. This account represented merchandise sold to Oregon Steel at regular prices (R. 95, 198, 371) (contrary to the court's findings) and upon which in the ordinary course of business Alaska Junk realized

and reported as taxable income the profits. As to this particular item the transaction is identical with an account created by any merchant selling its goods on open account.

Another important fact in connection with the RFC program leaning in petitioners' direction is the standby agreement required (Resp. Ex. C), dated December 26, 1942 and designating Alaska Junk and Morris as "Standby Creditors." This agreement is in the usual form provided by RFC. Among other things it provides for limiting salaries of "standby creditors"; that it shall remain in force until the RFC loan is repaid; and in paragraph No. 2.

> "Without the prior written consent of RFC, no standby creditor will take any action to assert, collect, or enforce all or any part of the claim."

Also respondent's Exhibit D, headed "Standby Agreement", refers to Alaska Junk as a "standby creditor" and states "with respect to the indebtedness owing by the borrower (Oregon Steel) to the 'standby creditor' ", Alaska Junk would not attempt to enforce payment of said indebtedness until RFC had been repaid in full.

Here RFC specifically recognizes the petitioners as creditors and the signing of these standby agreements in no wise affects the rights of these creditors to share upon liquidation as a general creditor.

The true intent of RFC with reference to the advances to Oregon Steel is clarified by Exhibit S, which is headed:

## "AGREEMENT AS TO LOANS TO OREGON STEEL BY ITS STOCKHOLDERS"

This heading indicates that RFC considered, at least, some of the advances as "loans," and also an indiscriminate use of the term capital investment.

Furthermore, the acceptance of debenture notes instead of stock in the face of availability of additional Oregon Steel shares clearly shows the fixed purpose (intent) of avoiding an additional capital investment in that company.

(f) *Re Agreement to Share Loss One-Third–Two-Thirds* (R. 48). No adverse inference may be drawn from this agreement. The advances were not in proportion to stock holdings at any time. From June 12, 1941 to March 11, 1943 Morris was in control of the corporation by reason of his being the promoter and owner of 1,251 shares (R. 41-47) and it was during this period that Alaska Junk made the major portion of advances (Ex. 26). At the time the debt was compromised Oregon Steel owed Alaska Junk $428,132.13 and Morris $26,493.77, total $454,625.90 (R. 50). Of the $151,000.00 note given in settlement Alaska Junk received $142,200.33 and Morris $8,799.67 (R. 392). Thus the settlement was based upon Oregon Steel's obligation to the respective creditors and not in proportion to stock holdings of one-third and two-thirds.

At the time the stock was originally subscribed for and during which the major amount of the advances was made there was no expectation of a loss. In fact, as the court found (R. 41):

"Oregon Steel was organized to erect and operate a rolling mill for the manufacture of steel products. Its stockholders planned to melt down and use scrap metal, which in 1941 was being sold in Portland at \$1.50 to \$2.00 a ton less than in Seattle, and on the basis of engineers' production estimates expected the earnings eventually to reach \$50,000.00 or more a month."

but the picture changed drastically in 1943. Morris was being inducted into the armed forces. The project was his, the business was being deprived of his energy and knowledge and since Alaska Junk had been drawn into it by Morris, it was only natural that petitioner, Wolf, particularly, would insist upon Morris sharing his portion of Alaska's losses, if any. But this agreement was not a primary obligation. It was only a guaranty, and did not change the obligation of Oregon Steel to Alaska and did not alter the position of Alaska Junk as a general creditor.

From journal entry (R. 52), it may be deduced that of the note of \$151,000.00 given by the new owners of Oregon Steel, Alaska Junk received \$142,200.33, representing 94.1724% of the total of the \$151,000.00, while Morris received only 5.8276% of this note.

| | |
|---|---|
| Morris Schnitzer's interest in two mortgage notes (R. 52) | \$ 83,799.67 |
| Less his part of debenture notes for \$249,000.00 (R. 46) | 75,000.00 |
| Balance | \$ 8,799.67 |
| Total of third mortgage note received | 151,000.00 |
| Balance received by Alaska Junk | \$142,200.33 |
| Percentage of note received by Alaska Junk, \$142,200.33 ÷ \$151,000.00 = | 94.1724% |

Morris, owner of one-third of stock Oregon Steel, received from the third mortgage note:

| | |
|---|---|
| Total third mortgage note | $151,000.00 |
| Received by Alaska Junk | 142,200.33 |
| Balance received by Morris Schnitzer | $ 8,799.67 |

Percentage of account recovered,
$8,799.67 ÷ $151,000.00 = 5.8276%

Thus the note was divided among the creditors in proportion to their advances and the court's reference to the relationship of the advances to the stock ownership is without merit.

(g) *Re Failure to Designate Use of Advances* (R. 67). The court complains that since no advance, whether by cash payment, materials supplied or discharge of the corporation's bills, was specifically designated as made in satisfaction of stock subscription, in payment for bonds or as a loan, this was a departure from essential form.

The charges to Oregon Steel were made from day to day, and since it was the purpose from the inception that all the items create debts until otherwise designated, the proper inference to be drawn from the books of account is that the parties intended to create a debt for the ENTIRE amount, unless otherwise designated.

This is fully borne out by the fact that only the amount of stock issued to Alaska Junk was charged to this account. This is also true with respect to the portion of the debenture notes accepted by Alaska Junk. These entries did specifically designate the amounts intended to be treated other than as an account.

Also directly in point is the testimony of Leon D. Margosian, a certified public accountant and the accountant for Oregon Steel, which shows conclusively how the funds were intended to be applied.

He testified (R. 452):

> " . . . These vouchers or invoices from Alaska Junk Company came to Oregon Steel in the same manner as all other vendors' invoices; we processed them in exactly the same way; we presented them to the Reconstruction Finance Corporation for payment along with other regular invoices; some of them were approved and paid. Those that were not approved and paid, we showed in accounts payable. . . ."

(R. 453):

> "Q. What is the basis for the statement?
>
> A. I was instructed by the owners of the firm and by Mr. Riley, their deceased accountant, that after my entry for the stock issued and the debentures had been placed on the books, all other amounts would be current and would be paid either out of the RFC funds or operating profits."

In spite of this positive testimony, no reference to which was made in the court's findings, it concluded there was no specific designation for the use of the funds. This testimony clearly points up the court's misconception of the facts.

(h) *Re Letter Morris Schnitzer March 18, 1943. (Resp. Ex. AA)* (R. 48). The court in referring to letter of Morris Schnitzer to RFC under date of March 18, 1943 and the statement therein contained "never intended to pay in over $500,000.00 . . . as our share of invested capital" views this document in the wrong

light. Again the use of the term "invested capital" is not significant. In the last paragraph of this letter to RFC in reference to their loan Morris stated:

> "Your share of the INVESTMENT here is guaranteed."

Also Morris explained this language (R. 407-8) as meaning a maximum capital of $250,000.00, $150,000.00 "working capital" and raw materials to help operate the plant.

(i) *Alaska Junk's Closing Entry* (R. 52). The books of account which were consistently maintained by Alaska Junk and Oregon Steel spell out the only proper conclusion concerning the advances of cash, goods sold and bills paid, and that is, these advances were intended to be and were debts. The force of this evidence is not dissipated, as the Tax Court assumed it was, by the closing entry partially quoted in its opinion. The Tax Court overlooked the fact that this entry covered "investment *and* account" of Alaska Junk. The matter was stated conjunctively. Far from being an indiscriminate lumping, this entry preserved the identity of each segment of the advances. It recorded not only "investment" but *also* the "open account."

Furthermore, the entry as quoted does not give a complete picture, in that it fails to show what a subsequent entry did with the loss there computed. Following the quoted entry the Tax Court paraphrased the subsequent entry into insignificance (R. 52). That entry actually read:

"To Transfer Balance of Account Lost in Settlement

of Account to Bad Accounts." (Exs. 6 and 26)

This demonstrates beyond contradiction that the entry quoted by the Tax Court was no more than the bookkeeper's summary of the various amounts which had been paid for stock and debentures and by way of extensions of credit to Oregon Steel. And it is unmistakably true that the purpose disclosed by both entries was to settle the loss sustained on the open account in accordance with the guaranty agreement.

The conclusion of the Tax Court with respect to this entry that "all advances, whether attributed to stocks, bonds, or *loans*" were "indiscriminately grouped for arriving at a settlement" is completely inconsistent with its finding that:

> "In connection with the bond issue and stock transfer Morris Schnitzer orally agreed with Sam and Rose Schnitzer and Harry J. and Jennie Wolf that he would bear one-third of any loss that might result from the *total amounts advanced and to be advanced* by all five to the corporation, *over and above the advances credited to stock subscriptions.*" (Italics added) (R. 48)

That the Tax Court classified all advances as being "attributable to stocks, bonds or *loans*" shows that it recognized the $202,350.60 constituted a loan or debt.

The Tax Court discounted the general importance and weight to be given book entries and in the same breath admitted being completely swayed by this one; this demonstrates it reached its result despite the evidence and its findings.

None of the evidence relied on by the Court supports the inferences drawn by it.

2. The Trier's Errors of Law.

Because of the court's erroneous understanding of the law, it rested its ultimate findings on facts which have little legal significance.

(a) *Parties' Formal Declarations.*

At the outset the Court stated a rule for interpretation of facts as follows:

> ". . . the parties' formal designations of the advances are not conclusive . . . but *must yield* to 'facts which *even indirectly* may give rise to inferences contradicting' them. *Cohen v. Commissioner,* 148 F. 2d 336 (C.C.A. 2d, 1945)." (R. 64; Italics inserted)

Petitioners submit this is not good law. In all lawsuits contradictory inferences may be drawn. But this is not to say such inferences control the result, nor that proved facts "must yield" to these inferences. An accurate statement of the rule is that in some circumstances other facts "may yield" to these inferences. Nor did the Court correctly quote the Court of Appeals in *Cohen v. Commissioner,* 148 F. 2d 336 (C.C.A. 2d, 1945). That court did not say that the facts "must yield" to conflicting inferences. It stated only that the uncontradicted witness *rule* must yield to contradictory inferences.

As a consequence of its adherence to this fallacious view of the law, the Tax Court misjudged the facts and their weight. Accordingly, its ultimate finding is no more than an erroneous view of the facts.

(b) *Use Made of Advances.*

The Tax Court also placed emphasis on the fact that the advances had been invested in permanent assets. Its view was that the use to which funds are put by the corporation determines the character of the advances. It adopted a standard in direct conflict with the *intent* standard, which this court (9th Circuit) has stressed. Its view was that, regardless of the intent with which the funds are advanced, the corporation's use of those funds determines whether they are capital or debt. According to this theory, in *Joseph B. Thomas,* 2 T.C. 193 (1943) the Tax Court should have held the advances were debts instead of capital, because permanent assets were not acquired. Likewise, bondholders of railroads and industrial concerns must really be stockholders.

The money borrowed from RFC, bank loans, and accounts payable of over $190,000.00 to outside persons went into permanent assets. Those funds were unquestionably loans. Obviously, this is no criterion, and reliance on this mistaken notion warped the view which otherwise would have been taken of the facts.

(c) *Repayment from Earnings.*

Another error of law was the view that if the corporation had paid off the advances from earnings, such payment would have been a dividend distribution on risked capital. Repayment of debts will always be made from earning unless the debtor is in such hopeless financial straits that it has no earnings and must make payments by depleting its available assets. Surely the Tax Court would not suggest as a rule of law that loans could be made only to the hopelessly insolvent. This is

contrary to established legal doctrine. *American Cigar Co. v. Commissioner*, 66 F. 2d 425 (C.C.A. 2d, 1933). The reasonable expectations are that debts and interest charges on debts will be repaid from earnings. See *Wilshire & Western Sandwiches, Inc. v. Commissioner*, 175 F. 2d 718 (C.C.A. 9th, 1949), where the creditors expected to be and were repaid from earnings, and this court held such facts consistent with a valid debtor-creditor relationship.

(d) *Adequacy of Corporate Capital.*

Another failure of the court to accredit the facts with their plain import resulted from complete reliance on the doctrine of "adequacy of corporation capital previously invested" as an indicium of the intent with which advances are made by stockholders to corporations, and reliance upon this doctrine gave the court a distorted impression of the facts. There are no judicial precedents supporting this doctrine as a test in determining the issue involved. The courts have always been concerned with the "intent" of the parties. The court here outwardly professed a similar concern when it enumerated various evidentiary factors which go to prove intent, but the inclusion of the adequacy factor shows its inclination to disregard the overbearing weight of evidence because of its commitment to this erroneous notion.

The decision of this court in *Maloney v. Spencer*, 172 F. 2d 638 (C.C.A. 9th, 1949), is proof enough of this. In that case the only capital of two food packing corporations was growers' contracts of $10,000 and

$5,000, respectively, and the sole stockholder had open account balances with the corporations of $33,966.02 and $61,115.48, respectively; yet this court held both accounts to be debts.

Also see *Cleveland Adolph Mayer Realty Corporation,* 6 T.C. 730 (1946), reversed on another point 160 F. 2d 1012 (C.C.A. 6th, 1947), wherein the stockholders of one corporation exchanged their stock therein for stock of $600 and debentures of $210,000 of another corporation. The court held the debentures constituted an indebtedness and the interest thereon deductible.

In *Fairbanks, Morse & Co. v. Harrison,* 63 F. Supp. 495 (Ill., 1945), plaintiff corporation purchased all the stock of another corporation for $7,110 and thereafter advanced it funds on open account, balance in which reached $796,056.17. Plaintiff claimed a bad debt loss of $128,466.63, and the court allowed it.

In *Glenmore Distilleries Co.,* 47 B.T.A. 213 (1942), the taxpayer owned all the subsidiary corporation's stock in the amount of $1,000.00. The taxpayer charged the subsidiary in an open account with merchandise and expenses paid, totaling $131,457.72. In liquidation a loss of $80,810.56 was sustained. The Commissioner contended the corporate capital was inadequate. Nevertheless, the Tax Court held the loss was deductible as a bad debt.

Similar is the leading case of *Edward Katzinger Co.,* 44 B.T.A. 533 (1941), where petitioner owned all the subsidiary's capital stock of $1,000.00. After advancing the subsidiary hundreds of thousands of dollars on open

account, it was liquidated with a loss of $28,950.06. The Tax Court found that the subsidiary's capital was "insufficient to enable it to carry on its business"; and although the Commissioner made a contention concerning "adequacy of corporate capital", the Tax Court held that petitioner's loss was a bad debt, saying:

> "The respondent argues that all of the funds advanced by the petitioner must be regarded as additional capital contributions since *Bruce-Hunt had to have more than $1,000 with which to conduct* its operations . . . the argument fails completely, insofar as it relates to the advances, by reason of the finding that those advances were loans." (Italics supplied)

In the case at bar the court used this erroneous doctrine as its major argument to sustain the holding reached, placing the greatest emphasis on the point of "adequacy".

Even though the court's construction of the law on this point were correct, its conclusion based upon the facts would still be erroneous. By its own finding Oregon Steel made a success with its paid-in capital of $187,800.00. After detailing the ownership of the stock as it was finally distributed (R. 47), in the last sentence of the first paragraph (R. 48) the court stated:

> " . . . No other shares were ever issued although in the beginning the organizers expected to issue more to associate promoters."

Also in the second paragraph (R. 52) the court stated:

> " . . . By 1947 corporate surplus exceeded a million dollars. . . ."

Also on this point respondent's witness, E. B. McNaughton, testified regarding the earnings of Oregon Steel (R. 443):

> "Q. What was the earned surplus for the year 1946?
> A. $379,568.00."

(R. 444):

> "Q. And for the year 1947?
> A. $1,191,501.00."

(R. 446):

> "Q. . . . Do you know whether this item of surplus included any items of paid-in surplus? . . .
> A. No, it does not."

(R. 447):

> "Q. Or paid-in surplus by the stockholder or resulting from any other means?
> A. No.
> Q. Your answer to the last question means that it does not represent any contributions, but represents earnings of the company?
> A. It is the result of the earnings of the company."

This earning record of Oregon Steel fully met the estimates of engineers that the mill would earn $50,000.00 or more per month (R. 41) and fully justifies Morris' expectations and promises. This record of earnings also completely refutes the court's claim of inadequacy of corporate capital as applied to the instant case.

(e) *INTENT the Established Criterion.*

Another erroneous view of the law is amply shown

by the court's statement on "intent" and the authorities cited (R. 63-4):

> " . . . And in deciding whether or not a debtor-creditor relation resulted from advances, the parties' true intent is *relevant, Fairbanks, Morse & Co. v. Harrison,* (N. D. Ill.), 63 Fed. Supp. 495; *Edward Katzinger Co., supra,* (44 BTA 533); *Daniel Gimbel,* 36 BTA 539."

The cases cited hold that INTENT is CONTROLLING, and this has been the fixed criterion for determining the classification of advances ever since *Edward Katzinger Co. v. Commissioner,* 44 B.T.A. 533, decided in 1941.

For additional cases supporting the proposition that "intent" is CONTROLLING: *Van Clief v. Helvering,* 135 F. 2d 254, 256; *Valentine E. Macy, Jr.,* 8 T.C.M. 45, 1949 Dec. 16,797 M-CCH-7197; *Edward Katzinger Co.,* 44 B.T.A. 531 (1941); *Fairbanks, Morse & Co. et al. v. Harrison,* 63 Fed. Supp. 495.

This court has also considered the question in two cases: *Maloney v. Spencer,* 172 F. 2d 638, decided February, 1949, and *Wilshire & Western Sandwiches, Inc. v. Commissioner,* 175 F. 2d 718, decided June 23, 1949. In *Maloney v. Spencer* the court stated:

> "The sums paid in . . . appear as debts due the taxpayer, both on his books of account and those of the corporations. . . . The question is what was the *taxpayer's intent in agreeing* to pay them. *Van Clief v. Helvering,* 135 Fed. (2d) 254, 256. . . . The *Van Clief* opinion, at page 256, states,
>
> " '*Edward Katzinger Co. v. Commissioner,* 44

BTA 533, 536 (CCH Dec. 11, 823). As said by the Board in the case last cited:

> " ' " . . . Advances are an additional contribution of capital if they *are intended to enlarge the stock investment,* but not if they are intended as a loan. *Daniel Gimbel (v. Commissioner),* 36 BTA 539 (CCH Dec. 9754); *Bernuth-Lembcke Co. (v. Commissioner),* 17 BTA 599 (CCH Dec. 5452); . . . ." ' "

Also in *Wilshire & Western Sandwiches, Inc. v. Commissioner, Supra,* the court stated:

> "The question presented is: Were certain advances of money made to petitioner by its stockholders loans or contributions to capital?
>
> . . . . .
>
> The *intent* of the parties as to the *nature of the transaction controls.*"

As this court stated in *Maloney v. Spencer, Supra,* in determining the same issue:

> "The sums paid . . . appear as debts due the taxpayer, both on his books of account and those of the corporations."

The court found in the case at bar the advances were recorded consistently on the books of both debtor and creditor as accounts payable and accounts receivable respectively from the time created until compromised and charged off.

In the *Wilshire* case the advances under attack were originally credited to capital stock accounts and later transferred to notes payable, lending some color to the capital contribution theory, yet this court reversed the Tax Court. Here, on the other hand, ALL ENTRIES

WERE CONSISTENTLY MADE TO DEBTOR-CREDITOR ACCOUNTS AND THEY SO REMAINED TO THE END. At no time did the petitioners attempt to convert "fish to fowl". This applied not only to the petitioners' and Oregon Steel's books but to the books of the companion company, Schnitzer Steel Products Co. Uniformity throughout. Yet the court said there was no adherence to form.

It is significant to note that from the very beginning the intention of Alaska Junk with respect to capital investment was unequivocally limited. On June 12, 1941 Alaska Junk subscribed for capital stock of Oregon Steel (R. 530; Stip, par. 11; Ex. 3). This subscription was made over four months *prior* to the time that Alaska Junk made its first advances in October (R. 42, Ex. 26). That the stock was subscribed for *prior to the advancement of one penny* by Alaska Junk shows beyond contradiction that their original intention was to limit the amount of capital investment.

The original intent of Alaska Junk, as disclosed by its stock subscription many months prior to the first advance, stamped the advances as a debt.

The primary facts found clearly establish an intention on the part of the petitioners to limit their capital investment by the amount of stock subscribed, and the court was not at liberty to disregard the clear, positive, unequivocal, unimpeached testimony of the witnesses called by the petitioner, none of whom were petitioners, that the petitioners did not intend the advances as capital investments but intended them as debts.

Thus, since the "intent" of the parties in making the payments is "controlling", it is obvious that the court was laboring under a misconception of the applicable law.

(f) *Relation of Advances to Stock Holdings.*

While it is true there is an agreement between Morris and Alaska Junk that losses sustained, if any, should be borne one-third and two-thirds and the stock was owned in these proportions, the advances were not in the same proportion. The settlement made with the new owners was on the basis of Oregon Steel's indebtedness to Morris and to Alaska Junk and not the agreement of the parties. Morris received 4.8276% of the settlement payment and Alaska Junk received 94.1724%, notwithstanding the stock ownership of one-third and two-thirds. The test is the obligation of the debtor to the creditor and not what an outside agreement of guaranty represents. Thus, so far as the debtor is concerned Alaska Junk stood to share in and did share in the settlement in proportion of its actual advances and not upon the basis of its stock ownership.

Even though the advances had been in proportion to stock holdings that would not have been fatal. In *Maloney v. Spencer, supra,* respondent was the sole stockholder and his advances would have of necessity been in proportion to his stock holdings. The court did not consider that that made the advances a contribution to capital.

Also in *Wilshire & Western Sandwiches, Inc. v. Commissioner,* the loans to the corporation were in

proportion to the stock ownership and with respect to that condition this court stated:

> "The effect of a lending and investing transaction giving creditors, as stockholders, proprietory interest in proportion to their loans, subjects the transaction to close scrutiny, but does not, as a matter of law, require the transaction to be treated as a stock investment, regardless of intent."

This but emphasizes the erroneous reasoning of the Tax Court.

## IV.

## Review of the Entire Record to Determine Error

Although this court concludes the inferences drawn by the trial court are supported by the primary facts FOUND, it must independently construe the entire record and draw therefrom the inferences it fairly induces.

The Supreme Court, in a very recent case (*United States v. U. S. Gypsum Company,* 1948, 333 U.S. 364) has stated the scope of the provisions of the Internal Revenue Code and Rule 52 (a) FRCP as follows:

> "It was intended, in all actions tried upon the facts without a jury, to make applicable the then prevailing equity practice. Since judicial review of findings of trial courts does not have the statutory or constitutional limitations on judicial review of findings by administrative agencies or by a jury, this Court may reverse findings of fact by a trial court where 'clearly erroneous'. . . . A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed."

In *Grace Bros., Inc. v. Commissioner,* 173 F. 2d 170, this court said in this connection:

> "This interpretation is not a new departure. It merely stresses, as courts of appeal (including this court), have done before, that findings are to be given the effect which they formerly had in equity. (Equity Rule 70½) Citing cases."

Thus, since the adoption of the FRCP, although due regard shall be given to the opportunity of the trial court to judge of the credibility of witnesses, nevertheless the appellate court may reverse "findings of fact" found by a trial court. We perceive this to mean that although the appellate court will not resolve a conflict in the testimony of witnesses it will review every phase of the record to determine if a mistake has been made by the trier in the inferences he has drawn from the evidence adduced. There is no such conflict for this court to resolve. The Tax Court challenged the testimony "particularly of Morris Schnitzer" only upon the fallacious reasoning that it "is INTELLIGIBLE only as showing an agreement about mere form". Pure sophistry.

The Record.

The credibility of petitioners' witnesses stands unchallenged. No attempt was made to establish their standing as to truth and veracity. That was unnecessary, but respondent's witnesses VOLUNTEERED testimony on that point. While respondent was endeavoring to induce his witnesses to testify that Morris Schnitzer or petitioners had made statements which

rebutted testimony that petitioners did not intend to invest more than $125,000.00 in the capital of Oregon Steel, they volunteered testimony that petitioners were highly regarded by the officers of The First National Bank of Portland (R. 441, 489 and 496, quoted pp. 12, 13, Br.).

Mr. Groth's testimony included the entire Schnitzer and Wolf families, thereby including all of the witnesses who testified as to what amount petitioners intended to invest in Oregon Steel stock.

Notwithstanding this background of credibility the court stated (R. 66):

> " . . . The testimony . . . is intelligible only as showing an agreement about mere form."

The court did not challenge the "credibility" of the witnesses but, rather, interpreted their testimony upon the basis of a preconceived notion of "intelligibility" as related to "form". It was saying "I believe the witnesses were telling the truth. However, I believe they meant to say petitioners never intended to put into Oregon Steel any more 'capital' as 'capital', but they did intend to put in more 'capital' as 'debts'. I don't believe they were lying. They just didn't understand the difference in the 'form'." Morris' consistent refusal to increase the capital of Oregon Steel shows he did understand the distinction.

Nothing appears in the record which in any particular tends to impeach the positive testimony of the witnesses, and nothing in the court's findings tends to do so.

Morris was not a PETITIONER; as he was promoting Oregon Steel, his brain-child, and was most anxious to successfully launch it, his natural inclination would be to do everything possible to meet the requirements of RFC and everyone else to obtain sufficient funds to get the operation under way, yet he steadfastly represented to everyone he approached that the "MAXIMUM CAPITAL" was to be $250,000. When he was called into service early in 1943, he became aware he could not put in more than $62,500 and that Alaska Junk WOULD NOT put in more than $125,000; he had agreed to reserve stock for Rosenbaum on the basis of $250,000 capitalization and wanted some for a corporate manager. Although he was advised by various concerns that if he would increase the company's capital, loans would be made, he consistently refused to do so. This testimony has added weight because it expresses the attitude of a witness other than petitioners. Because it was his project, it was to his interest to INDUCE Alaska Junk to subscribe for more stock, if that had been possible. Sam Schnitzer was his father and it would have been natural for him to "go the limit" for his son, but Wolf was absolutely opposed to taking more than $125,000 of stock on behalf of petitioners. None of the witnesses except Monte L. Wolf were petitioners in this proceeding and their testimony was not subject to being colored by self interest.

For the court's convenience the testimony of witnesses on petitioners' intent is summarized:

Morris Schnitzer:

R. 83 I subscribed for 1,251 shares of Oregon Electric Steel stock because I wanted to have control of the corporation.

R. 87 . . . this plan was promoted on my idea. I started working on it in 1941, at which time costs were very much lower than they were in later years. We made three different engineering reports and each time each report was a little higher. We never intended to invest so much capital.

R. 88 I had to spend two years in Washington, D. C. trying to get money, but the amount of capital that we could have put in has never been altered. I don't think that we made any statement anywhere that we ever intended to put in over $187,000.00 capital stock; . . . we didn't want to put in any more money than we had to.

R. 89 Mr. Wolf never wanted to put in any more than $125,000 towards capital.

At the time the company was formed we had a man in New York by the name of Mr. Rosenbaum who was given money for helping us and he was to be given 12½% of the company's stock for his services. We had to keep some open for him and we wanted to have Mr. L. G. Knight come in with an interest in stock and operate the company.

R. 97 But he (Mr. Rosenbaum) was in Portland in conjunction (R. 98) of setting up the capital stock of Oregon Electric Steel Rolling Mills and he recommended a capitalization of $250,000.00.

R. 104 I definitely told Commercial Credit Company that we were limited to the $250,000.00 capital which had been authorized. We told them it would be a maximum capital of $250,000.00.

R. 107 The McDonald report contained a statement that the maximum cost of the mill would be around $700,000.00 and our maximum capital

was to be $250,000.00 that we would invest.

R. 108 We would ask for $450,000 or $500,000 loan from the RFC and $250,000 capital (to make up $700,000).

R. 109 We told McDonald Engineering Company it was our intention to authorize stock of only $250,000.

R. 139 The reason I figured the $250,000 for authorized capital was because in our original estimates it would come to about $700,000.00; with a loan intended to be some $400,000.00 to $450,000.00 and $250,000.00 of our own.

R. 140 We asked Dulien Steel Products, Jack Barde of Barde Steel Company and Sid Woodbury of Woodbury Steel Co. to buy stock with two things in mind; first, to get some capital and to get them as steel jobbers.

R. 141 It was not only a question of getting more capital but to get more buyers and consumers and with the added prestige we thought that their names would help us.

R. 407 The original intention of the $500,000 was a maximum of $250,000 in capital stock, and we agreed in our pro forma statement to advance $150,000 in working capital and raw materials to help operate the plant.

R. 408 I did not expect Alaska Junk to put in any part of the additional capital that went into Oregon Steel beyond the amount they ultimately subscribed for.

Manuel Schnitzer:

R. 184 I discussed our company's financial affairs with our accountants quite often, and depended upon them for technical advice; they advised me that ($125,000.00) (R. 182-185) was the MAXIMUM that we could afford to put into the company.

R. 187 Mr. Wolf always maintained that he would not put in any more than $125,000.00 on behalf of Alaska Junk company partners, and they agreed not to put in over $125,000.00.

R. 250 On cross examination: I didn't say we couldn't afford the loss ($125,000.00). We could not afford to invest in Oregon Steel Rolling Mills more than $125,000.00.

M. R. Schnitzer (accountant for Alaska Junk Company):

R. 311 We were agreed that the Alaska Junk could afford some $62,500.00 and later again the question came up as to whether we could afford $125,000.00 rather than $62,500.00, and I suggested that if they went beyond $125,000.00 and tied it up in non liquid form that they might jeopardize the credit of Alaska Junk and thereby their own safety.

R. 312 They owed the bank between $200,000.00 and $225,000.00 and private individuals between $35,000.00 and $40,000.00 and liquid accounts receivable of approximately $170,000.00 or $180,000.00.

R. 319 I heard Mr. Wolf remark about the investment that Alaska Junk would make in Oregon Steel. Under the original plan he told me that the commitments of Alaska Junk were $62,500.00, and although he was not too happy about it (R. 320) he said he would go on behalf of Alaska Junk to $125,000.00, *but that was all;*

Monte L. Wolf:

R. 372 My father and mother had agreed with Mr. Schnitzer and the Schnitzer family that, as far as the Alaska Junk Company was concerned, all they wished and saw clear to invest in the Steel Mill was $62,500.00. My father said he

did not want to put any more in stock, but after discussing the matter mother and father agreed to take part of the shares of Morris Schnitzer on behalf of Alaska Junk.

R. 374 It was never intended to put in any more on the part of Alaska Junk Company than their final investment in the capital stock of the Oregon Steel.

Leon D. Margosian:

R. 452 . . . These vouchers or invoices from Alaska Junk Company came to Oregon Steel in the same manner as all other vendors' invoices; we processed them in exactly the same way; we presented them to the Reconstruction Finance Corporation for payment along with other regular invoices; some of them were approved and paid. Those that were not approved and paid, we showed in accounts payable.

R. 453 Q. What is the basis for the statement?

A. I was instructed by the owners of the firm and by Mr. Riley, their deceased accountant, that after my entry for the stock issued and the debentures had been placed on the books, all other amounts would be current and would be paid either out of the RFC funds or operating profits.

The foregoing testimony was not weakened on cross, and there is not a scintilla of contradictory testimony; nor do the documents adverted to by the court, when analyzed in their true light, rebut this testimony; nor is the testimony of petitioners' witnesses "inherently improbable". It is, therefore, plain that a mistake was committed by the trier.

On this point Judge Simon stated in *Lawton v. Commissioner,* 164 F. 2d 385-388 (C.C.A. 6th, 1947):

"We are aware, of course, that the Tax Court is not required, at all events, to believe the testimoney of witnesses, or even to accept at face value documents offered in evidence, but it appears to be well settled that the fact finder may not arbitrarily disregard undisputed and uncontradicted testimony of unimpeached persons where he has already found facts which lend a flavor of truthfulness to their assertions. *Hughes v. Commissioner,* 153 F. 2d 712 (5th CCA); *Bardach v. Commissioner,* 90 F. 2d 323, 326 (6th CCA); *Volz v. Treadway and Marlatt,* 59 F. 2d 643 (6th CCA).

This court's position is stated in *Grace Bros., Inc. v. Commissioner, supra,* in the following language:

"It is axiomatic that uncontradicted testimony must be followed. (*Chesapeake and Ohio Ry. v. Martin,* 1931, 283 U.S. 209, 216-217; *San Francisco Association for the Blind v. Industrial Aid,* 8 Cir., 1946, 152 Fed. (2d) 532, 536; *Foran v. Commissioner,* 5 Cir., 1948, 165 Fed. (2d) 705.) The only exception to the rule occurs when we are dealing with testimony by witnesses who stand impeached and whose testimony is contradicted by the testimony of others or by physical or other facts actually proved or in the case of testimony which is inherently improbable."

## CONCLUSION

The only reasonable conclusion upon the record is that the controverted advances were intended to be, and were, debts and that the loss therefrom was fully deductible in the year 1943.

The court was not at liberty to disregard the clear, positive, unequivocal and unimpeached testimony that

the petitioners did not intend the advances to be capital investment, but that they intended them to create debts.

The Tax Court's conclusion, therefore, is not justified. The testimony was straight forward, none of the witnesses were petitioners. There has been no claim of sham or tax avoidance. No witnesses called by respondent controverted the testimony, it is not "inherently improbable", and petitioners' course of conduct was consistent with the testimony.

It follows that the decision of the Tax Court was plainly erroneous, should be reversed and judgment entered for petitioners allowing the deduction as a bad debt in 1943.

Respectfully submitted,

ROBT. T. JACOB and
JACOB & BROWN,

Attorneys for Petitioners.

GARTHE BROWN,
Of Counsel.

# APPENDIX

Internal Revenue Code:

"Sec. 23. DEDUCTION FROM GROSS INSOME.

In computing net income there shall be allowed as deductions:

. . . . .

(k) Bad Debts.

(1) General Rule. Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection.

(4) Non-Business Debts. In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchanges during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

Treasury Regulation 111:

"Sec. 29.23 (k)-6 Non-Business Bad Debts.—In the case of a taxpayer, other than a corporation, if a non-business bad debt becomes entirely worthless within a taxable year beginning after December 31, 1942, the loss resulting therefrom shall be treated as a loss from the sale or exchange of a capital asset held for not more than six months. Such a loss is subject to the limitations provided in section 117 with respect to gains and losses from the sale and exchange of capital assets. A loss with respect to such a debt will be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a non-business debt which is recoverable in part during the taxable year. Nor are the provisions of this subdivision applicable in the case of a loss resulting from a security as defined in section 23 (k) (3). A non-business debt is a debt, other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business and other than a debt evidenced by a security as that term is defined in section 23 (k) (3). The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23 (e) is 'incurred in trade or business' under paragraph (1) of that section.

The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the

trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purposes of this section.

To illustrate: A, an individual engaged in the grocery business and who makes his income tax returns on the calendar year basis, extends credit on an open account to B in 1941.

(1) In 1942 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1943. A's loss is controlled by the non-business debt provisions. While the original consideration was advanced by A in his trade or business, the loss was not sustained as a proximate incident to the conduct of any trade or business in which he was engaged at the time the claim became worthless.

(2) In 1942 A sells the business to C but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(3) In 1942 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands. C's loss is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim or acquire it in carrying on his trade or business, the loss was sustained as a proximate incident to the

conduct of the trade or business in which he was engaged at the time the debt became worthless.

(4) In 1942 A dies, leaving the business to his son, C, but the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(5) In 1942 A dies and while his executor, C, is carrying on the business, the claim against B becomes worthless. The loss sustained by A's estate is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim on behalf of the estate or acquire it in carrying on a trade or business in which the estate was engaged, the loss was sustained as a proximate incident to the conduct of the trade or business in which the estate was engaged at the time the debt became worthless.

(6) In 1942, A, in liquidating the business, attempts to collect B's claim but finds that it has become worthless. A's loss is not controlled by the non-business debt provisions, since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

The provisions of this section with respect to non-business debts are applicable only to taxable years beginning after December 31, 1942."